

BFT & P

Quarterly



**BEHAVIORAL FINANCE: THEORY & PRACTICE Quarterly; a Newsletter Publication
of the Academy of Behavioral Finance www.aobf.org**

Volume 1, Issue 1, Fall 2010



ANNOUNCEMENTS/REPORTS

POPULAR DISCUSSION THREADS

HOT PICKS

ACADEMICS corner

PRACTITIONERS corner

MARKET MELTDOWN

EXTRAS

**A Session at the 2010 Annual Meeting of the Academy of
Behavioral Finance & Economics at DePaul University in Chicago**

BFT&P

CONTENTS

ANNOUNCEMENTS/REPORTS 3

POPULAR DISCUSSION THREADS 4

HOT PICKS 4

What Would An Evil Behavioral Economist Do?
Under Pressure: The Impact of Stress on Decision Making
Behavioral Finance's Smoking Gun

ACADEMICS corner 5

The Theory of Judgment and its Application to Behavioral Finance
CEO Overconfidence and the Impact on M&A Activity
Major Moral Decisions Use *General-Purpose* Brain Circuits to Manage Uncertainty
Do Investors See Through Mistakes in Reported Earnings?
Behavioral Portfolio Analysis of Individual Investors
The Trouble with Investment Banking: Cluelessness, Not Greed
Mental Accounting and False Reference Points in Real Estate Investment Decision-Making
"Take it or leave it?" Brain imaging study reveals interplay of thought and emotion in economic decisions

PRACTITIONERS corner 7

This is Your Brain on Stocks
Investors Throwing Market Fundamentals Out The Window...
Beliefs, Preferences, and Biases Investment Advisors Should Know About
Using Behavioral Finance to Better Understand the Psychology of Investors
Beat *Your* Investing Biases
11 Reasons Why What You Think Could Be Wrong
CRASH COURSE Prospect Theory: Psychology of Decision Making

MARKET MELTDOWN 9

'Emotional Inflation' Leads To Stock Market Meltdown
Reflection on a Crisis—VIDEO

EXTRAS 9

What's Your Financial IQ?_Take the Cognitive Reflection Test
Is Your Investing Personality in Your DNA?
Unpredictably Rational

ANNOUNCEMENTS/REPORTS



Second Annual Meeting of the Academy of Behavioral Finance & Economics- 2010 September 15-17, 2010, Chicago, Illinois www.aobf.org

The just concluded Meeting of the Academy of Behavioral Finance & Economics was held on September 15-17, 2010 at DePaul University's Conference Center in Chicago, Illinois, USA. Dr. John R. Nofsinger chaired and led the highly successful conference which attracted presenters and attendees from across the U.S. and across the world. Over 60 papers, screened, reviewed, and selected from among a strong pool of submissions, were presented at the annual conference. For a copy of the Program you may click [here](#) and for the Conference Proceedings book you may click [here](#).

DePaul University's Finance Department and faculty, under the leadership of Dr. Ali Fatemi, Chair of Finance Department, co-sponsored the conference and further enriched the 2010 Program in many different ways. Dr. Harold Welsch, Coleman Chair in Entrepreneurship at DePaul, spoke on entrepreneurship and related issues at the start of the meeting. Professor Werner DeBondt, the Richard H. Driehaus Chair in Behavioral Finance at DePaul, delivered the



ABF-2010 Keynote Speaker-Werner DeBondt

highly energizing Keynote Address, entitled "Animal Spirits". Academy of Behavioral Finance and its sister organization, Academy of Entrepreneurial Finance are very much grateful for DePaul University's wonderful support of their 2010 Annual Meeting in Chicago. ABF also recognizes and appreciates Dr. Robert Olsen's much valuable support of the organization.



ABF-2010 Program Chair-John Nofsinger

At the end, preparations are already under way for our upcoming Annual Meeting in the "City of Angels"- Los Angeles, California. Arrangements are being finalized with a world-class research university in Southern California to co-sponsor the 2011 ABF Meeting. Please mark your calendars for September 21-23, 2011 in Los Angeles. Our website www.aobf.org will have more detailed info on the event by mid-November.

Cheers!
ABF Management and Staff

POPULAR DISCUSSION THREADS

At Our BFT&P Group: WWW.AOBF.ORG

Select **Behavioral Finance: Theory & Practice** from Menu Items

Needed: A New Economic Paradigm

By Joseph Stiglitz

Recommended by Skip Sorenson

Retirement Income Specialist at Income for Life Advisors

Luck Or Skill - What Is More Critical To An Exceptional Investor (Or Even A Completely Worthless One)?

Recommended by Darren Agombar

Behavioral Finance Advisory - Claradan & ClaradanMetrics

The Biology of Business Homo Administrans

Recommended by Angela A. Stanton

Research Affiliate at Max Planck Institute for Economics

Quants vs. Behavioralists: Is "Quantitative Behavioral Finance" an Oxymoron?

Recommended by R. (Russell) Yazdipour

Finance Professor at CSU and Principal at Financial Decision Making Institute- FDMI

Working Paper: How the Risk Premium Factor Model and Loss Aversion Solve the Equity Premium Puzzle

Recommended by Steve Hassett

General management, corp development, M&A, product management, strategy new ventures in high-tech and digital media

HOT PICKS

What Would An Evil Behavioral Economist Do?

August 23, 2010

Tim Harford

"You inched towards the dark side," joked one behavioral economist after he read a recent column in which I hinted that his field has some merits. It was a quip that got me thinking, because behavioral economics does indeed have a dark side... if they are any good at their task they will discover something the unscrupulous salesman could use to his advantage.

Undercover Economist

<http://timharford.com/2010/08/illuminating-advice-on-the-dark-art-of-%E2%80%98drip-pricing%E2%80%99/>

Under Pressure: The Impact of Stress on Decision Making

Sep. 16, 2009

We are faced with making decisions all the time. Often, we carefully deliberate the pros and cons of our choices, taking into consideration past experiences in similar situations before making a final decision. However, a new study suggests that cognitive stress, such as distraction, can influence this balanced, logical approach to decision making.

ScienceDaily

<http://www.sciencedaily.com/releases/2009/09/090915174459.htm>

Behavioral Finance's Smoking Gun

July 2010

Linda

Here's a classic demonstration of behavioral finance in action, proving the irrationality of humankind. It's the (in) famous Linda problem:

Linda is 31 years old, single, outspoken and very bright. She majored in philosophy. As a student, she was deeply concerned with issues of discrimination and social justice, and also participated in antinuclear demonstrations. Which of these two alternatives is more probable?

(a) Linda is a bank teller.

(b) Linda is a bank teller and is active in the feminist movement.

The Psy-Fi Blog

<http://www.psyfitec.com/2010/07/behavioural-finance-smoking-gun.html>

The Theory of Judgment and its Application to Behavioral Finance

September 7, 2010

Jing Chen

Returns of stock prices often exhibit cycles of momentum and reversal. During various phases of the cycles, trading volumes and trading behaviors of investors of different sizes often show distinct characteristics. It has been a long standing challenge to describe the multiple patterns simultaneously from a quantitative theory. In this paper, we present the theory of judgment, which provides a common framework to integrate behavioral and informational theories of investment. The theory of judgment provides a quantitative link between investors' judgment and their trading activities. As an application, a simple mathematical model based on the theory of judgment is constructed. The predictions derived from the model are consistent with the multiple empirical patterns of trading volumes and investor activities at the different phases of the cycle of momentum and reversal.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1673470

CEO Overconfidence and the Impact on M&A Activity

September 1, 2010

Bernardo P. Bressane
Marcelo Verdini Maia

What drives mergers and acquisitions decisions? Can an overconfidence bias affect decisions within the management team? This study complements recent work developed within the behavioral finance analyses of Mergers & Acquisitions and proposes the use of new variable to measure overconfidence. Using a sample of 8,895 takeover transactions completed by 993 CEOs in the United States – between 1992 and 2008 – it can be noticed that overconfident CEOs have 22% higher odds of engaging in corporate takeovers than rational CEOs.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1674467

Major Moral Decisions Use General-Purpose Brain Circuits to Manage Uncertainty

August 25, 2010

Steve Bradt

(PhysOrg.com) -- Scientists at Harvard University have found that humans can make difficult moral decisions **using the same brain circuits** as those used in more mundane choices related to money and food.

For example, how did President Truman decide to deploy nuclear weapons against Japan in 1945, ending World War II, but at an enormous cost?" asks Greene. "Our results suggest that such decisions employ the same basic mechanisms our brains use when we evaluate whether it's worth spending a few hundred dollars for an extended warranty on a new car..."

<http://www.physorg.com/news201955984.html>

Do Investors See Through Mistakes in Reported Earnings?

September 9, 2010

Katsiaryna Salavei Bardos
Joseph H. Golec
John P. Harding

This study investigates whether investors see through materially misstated earnings, and whether they anticipate earnings restatements. For firms that restate at least one annual report, we find that investors are misled by mistakes in reported earnings at the time of initial earnings announcements. Investors react positively to the component of the favorable earnings surprise that will subsequently be restated, and attach the same valuation to it as to the true earnings surprise.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1092256

Behavioral Portfolio Analysis of Individual Investors

June 24, 2010

A. O. I. Hoffmann
Hersh Shefrin
Joost M.E. Pennings

Existing studies on individual investors' decision-making often rely on observable socio-demographic variables to proxy for underlying psychological processes that drive investment choices. Doing so implicitly ignores the latent heterogeneity amongst investors in terms of their preferences and beliefs that form the underlying drivers of their behavior. To gain a better understanding of the relations among individual investors' decision-making, the processes leading to these decisions, and investment performance, this paper analyzes how systematic differences in investors' investment objectives and strategies impact the portfolios they select and the returns they earn.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1629786

The Trouble with Investment Banking: Cluelessness, Not Greed

August 18, 2010

William Bunting

We assume that the set of marketable financial instruments can be divided into two distinct categories: (1) easy-to-price and (2) difficult-to-price, and then isolate two behavioral effects as most important with respect to securities trading in difficult-to-price securities; specifically, the house-money-effect and the earned-money-effect. It is shown that these behavioral effects discourage profitable investment in research effort.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1660624

Mental Accounting and False Reference Points in Real Estate Investment Decision- Making

June 22, 2010

Michael Joseph Seiler
Vicky L. Seiler
Mark Lane

This study examines a number of behavioral finance issues as they relate to real estate investments. We find a statistically significant degree of mental accounting at all points throughout the disposition effect curve when holding a real estate investment in isolation versus holding the asset as part of a mixed-asset portfolio. We also identify four distinct disposition curve shapes beyond the traditional "S-shaped" curve where investors are more willing to sell an asset that is in the gains domain. Further, we conclude that an investor's willingness to sell jumps by the greatest amount when going from zero return into profitable territory.

Journal of Behavioral Finance, Forthcoming
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1625407

"Take it or leave it?"

Brain imaging study reveals interplay of thought and emotion in economic decisions

Steven Schultz

"When we explain the game to people they often ask, 'So why would I ever reject an offer? What's the trick?' And we say, 'There's no trick; if you reject an offer you don't get any money; if you accept the offer, you get it.' And they say 'OK.' And yet when they get in there and receive an unfair offer, oftentimes they reject it. There's an element of feeling a little betrayed.

<http://www.princeton.edu/pr/pwb/03/1208/7a.shtml>

This is Your Brain on Stocks

Andrew Beattie

Most participants started out making rational trades; the rational, pleasure and pain centers of the brain were most active, but the rational center was dominant. After an unexpected gain or loss, however, the pleasure and pain centers became more dominant and increased the probability of the subject making an irrational decision...

Trading for Trading's Sake

The main issue brought up by Knutson's findings is the addictive nature of **trading as an activity**, separate from the realization of losses or gains...

The results of the study suggest that **money itself**, or rather the act of accumulating money, **may be the reward**. Knutson found that rapid trading itself - the deluge of information requiring quick decisions - can actually force a person's mind into a state in which he or she **will naturally make more mistakes**.

Intelligent Investing Panel

<http://www.investopedia.com/articles/stocks/08/mind-behavior-investing.asp>

Investors Throwing Market Fundamentals Out The Window...

July 24, 2010

Nathaniel Popper

"Jim Paulsen has a PhD in economics and more than a quarter-century of experience as an investment strategist... was taught to evaluate investments based on "the fundamentals", chief investment strategist at Wells Capital Management, a Wells Fargo & Co. unit that manages more than \$300 billion in investments."

Stocks' gyrations defy explanation

<http://articles.latimes.com/2010/jul/24/business/la-fi-market-disconnect-20100716>

Beliefs, Preferences, and Biases

Investment Advisors Should Know About

September 19, 2008

Daniel Kahneman

Mark W. Riepe

Financial advising is a prescriptive activity whose main objective should be to guide investors to make decisions that best serve their interests. To advise effectively, advisors must be guided by an accurate picture of the cognitive and emotional weaknesses of investors that relate to making investment decisions: their occasionally faulty assessment of their own interests and true wishes, the relevant facts that they tend to ignore, and the limits of their ability to accept advice and to live with the decisions they make. This article sketches some parts of that picture, as they have emerged from research on judgment, decision-making and regret over the last three decades. (See "A Checklist for Financial Advisors")

Journal of Portfolio Management

<http://www.scribd.com/doc/4882845/Aspects-of-Investor-Psychology>

Using Behavioral Finance to Better Understand the Psychology of Investors

May 12 2010

Charles Wallace

Fund managers are using behavioral finance concepts to select stocks and construct portfolios.

Robert Shiller, a professor of economics at Yale University, made a prediction in 2005 that a massive bubble was developing in the housing market, and was proved right just two years later, it seemed a mortal blow for classical finance. Shiller is one of the founders of behavioral finance, a school of economics that believes that the psychological behavior of investors can have a big impact on markets.

Fund managers employing behavioral finance believe that investors make mistakes because of cognitive and emotional biases —such as a presumption that a stock that has performed well in the past will continue to do so far into the future — that cause equity prices to either overreact or underreact to market news.

It is these mispricings that behavioral finance strategies attempt to exploit.

So how does it work?

<http://www.iimagazine.com/Popups/PrintArticle.aspx?ArticleID=2485942>

Beat *Your* Investing Biases

June 15, 2009

David Serchuk

Most of our decisions, including in investing, are made without conscious thought. Use behavioral finance to beat these traps.

Although investors like to think that they make their decisions based on rational thinking this is hardly the case, argues Michael Ervolini. Ervolini, the head of Cabot Research, makes his living by applying the lens of behavioral finance to how professional investors invest. What his firm has found is that emotional, often subconscious, decisions undercut even the best investors by up to 150 basis points a year.

FORBES

<http://www.forbes.com/2009/06/15/behavioral-finance-emotions-intelligent-investing-psychology.html>

11 Reasons Why What You Think Could Be Wrong

August 6th, 2009

Steve Christ

As the concept of behavioral finance implies, there is always a ghost in the machine. And because of this ghost, things aren't always as they appear to be — especially when it comes to the stock market. . .

The reason for this, of course, is simple: **the markets are made up of people.**

The key here...is in learning to recognize **how the cognitive biases related to behavioral finance have handicapped your investing** in the first place.

WEALTHDAILY

<http://www.wealthdaily.com/articles/behavioral-finance-theory/1929>

CRASH COURSE

Prospect Theory: Psychology of Decision Making

Dirk Olin

From the infamous Dutch tulip hysteria of the 17th century to the Great Depression to the dot-com crash, wild bouts of speculation have occasionally inflated big fat financial bubbles that soaked investors when they burst. Daniel Kahneman, a professor at Princeton who was the first psychologist to win the Nobel in economics (which he was awarded last year for studies he conducted with Amos Tversky), has attributed market manias partly to investors' "illusion of control." Kahneman recently explained the basic weirdness of the dot-com bomb to The Financial Times: "A high percentage of investors knew it was a bubble and still invested because they thought they could get out in time." Why did so few heed the alarms?
New York Times

<http://www.nytimes.com/2003/06/08/magazine/o8CRASH.html>

MARKET MELTDOWN

'Emotional Inflation' Leads To Stock Market Meltdown

April 30, 2008

Investors get carried away with excitement and wishful 'phantasies' as the stock market soars, suppressing negative emotions which would otherwise warn them of the high risk of what they are doing, according to a new study led by UCL (University College London). Economic models fail to factor in the emotions and unconscious mental life that drive human behavior...

<http://www.sciencedaily.com/releases/2008/04/080429095042.htm>

Reflection on a Crisis—VIDEO

January 27, 2009

Nobel Laureate **Daniel Kahneman** and **Nassim Taleb** (author of **The Black Swan**) discuss the intricacies of the financial crises and its far-reaching influence.

Looking forward, they offer proposals to remedy the situation and prevent it from ever recurring.

FORA.tv

http://fora.tv/2009/01/27/Nassim_Taleb_and_Daniel_Kahneman_Reflection_on_a_Crisis

EXTRAS

What's Your Financial IQ?

Take the Cognitive Reflection Test

July 16, 2009

These particular questions are the mental equivalent of optical illusions. They **appear to be easy**, but aren't. Tests of similar complexity which are more obviously difficult yield more correct answers so it's not simply a question of basic math skills. Something else is going on here.

The Psy-Fi Blog

<http://www.psyfitec.com/2009/07/whats-your-financial-iq.html>

Is Your Investing Personality in Your DNA?

April 4, 2009

Jason Zweig

Maybe your DNA made you do it.

Whatever investing mistake you have committed lately, there is probably a gene that is often associated with that behavior. Are you predestined to be the prisoner of your genetic code?

THE INTELLIGENT INVESTOR

<http://online.wsj.com/article/SB123879381940987845.html>

Unpredictably Rational

April 3 2010

The definition of rationality that's at the centre of modern economics is a strange conceit, based around the idea of maximizing utility. Underlying this is an assumption that **rationality means that we're consistent in our choices**: faced with the same situation we should always do the same thing.

However, **real-life isn't like this**.

We rarely, if ever, face the same situation twice. We even make different choices ourselves between *very similar* circumstances and most of us will see nothing wrong in this.

As Keynes himself said, when the facts change you should change your mind: it would be stupid not to.

The Psy-Fi Blog

<http://www.psyfitec.com/2010/04/unpredictably-rational.html>



ABF-2010; Friday Working Lunch Session

About the Academy Of Behavioral Finance & Economics



www.aobf.org

Mission Statement

The mission of the Academy of Behavioral Finance & Economics (ABF) is to offer a dedicated forum for exchange of research findings and professional advancement related to the fast-growing field of behavioral finance and economics.

ABF's Key Areas of Interest:

- Investment and the Working of Financial Markets at all levels of functionality and capital allocation—including both public and private aspects;
- Financial Management of Companies-both public and private entities;
- Firm Entry and Exit Process-ranging from startup ventures to mature businesses;
- Entrepreneurship, Innovation, and Venture Capital;
- All other Business and Economic Endeavors that Involve Human Decision Making and Choice Under Conditions of Risk and Uncertainty;
- Teaching and Learning—ranging from case development to other pedagogical issues.

Contact Information:

Email: staff@aobf.org
Phone: 818-236-2145
Web: www.aobf.org

Mailing Address:
Academy of Behavioral Finance & Economics
P.O. Box 157
Montrose, CA 91021-0157

ABF Groups on LinkedIn

Behavioral Finance: Theory and Practice (BFT&P)

The goal of the “Behavioral Finance: Theory & Practice” Group is to provide a one-stop networking place for exchange of behavioral-finance-based research issues and practical problems and solutions that face both the academics and practitioners in the field. Discussions should focus on either the theory (academic), practice (professional), or both (theory and practice).

To Visit BFT&P: Select BFT&P Group from ABF’s Menu Items at our site: www.aobf.org

NeuroFinance & NeuroEconomics Group

A Subgroup of Behavioral Finance: Theory and Practice

This Group is organized and managed by the Academy of Behavioral Finance & Economics (ABF) and its mission follows ABF’s mission of offering “a dedicated forum for exchange of research findings and professional advancement related to the fast-growing field of behavioral finance and economics.

Behavior Finance Theory Group

Behavioral Finance Theory (BFT) Group is organized and managed by the Academy of Behavioral Finance & Econ <http://www.aobf.org/> and its main goal is to help create the next generation of behavioral finance models and theories. This is done by providing an inclusive research environment that no physical Ivy League school can provide. The BFT Group held its first Annual Dinner Meeting in conjunction with ABF-2010 in Chicago.

To Visit BFT&P: Select BFT&P Group from ABF’s Menu Items at our site: www.aobf.org

ABF Groups on LinkedIn- Continued

Behavioral Finance Teaching & Learning Repository

A Subgroup of Behavioral Finance Theory Group

If behavioral finance, as an academic field/sub-field, is to gain traction and receive the academic and professional respect that it certainly deserves, it must ALSO be taught at undergraduate, graduate, and professional levels. Although we do not have a national report on the subject, but at the present time, only a few schools in the US offer such classes and UMUC is one of the firsts in the US. Also, as far as we know, the only published work on the issue is the one conducted by two members of this Group/ABF (Jim Howard and R. Yazdipour 2010). On the other hand, it seems like more and more finance academics get drawn to the area for various reason. And here lies the opportunity for us.

Consequently, and in accordance with its mission, and as further support for the “BF Theory” Group, ABF has also taken the leadership role in creating “The Behavioral Finance Teaching & Learning Repository”. This repository functions as a space where content is collected, organized, and maintained for use by any interested faculty or university. Content can vary from syllabi and handouts to assignments and even evaluation instruments (exams).

Credit: We would like to acknowledge and appreciate the following sources for providing content for most of the materials in this Newsletter. They are:

Undercover Economist
The Psy-Fi Blog
ScienceDaily
Physorg.com
SSRN
Princeton.edu
Investopedia
Scribd.com
LA Times
Forbes
New York Times
Wall Street Journal
Fora.TV
WealthDaily.com
Time Magazine

Advances in Behavioral Finance & Economics

**The Journal of the Academy of Behavioral
Finance & Economics**

Volume 1, Issue 1, January 2011

**Editor:
John R. Nofsinger, Ph.D.
Washington State University**

Forthcoming, Winter 2011



**A Publication of the Academy of Behavioral Finance & Economics
Los Angeles, California, USA**

BFT & P

Quarterly



BEHAVIORAL FINANCE: THEORY & PRACTICE Quarterly; a Newsletter
Publication of the Academy of Behavioral Finance www.aobf.org
Volume 1, Issue 1, Fall 2010

Editorial Office

Editor:

R. Yazdipour, Ph.D.
Academy of Behavioral Finance

Managing Editor and Art Director:

Anaheita Pourian
Academy of Behavioral Finance

Production And Webmaster:

Arun Vignesh K. Aruchamy

Contact Information:

Email: staff@aobf.org
Phone: 818-236-2145
Web: www.aobf.org

Mailing Address:
Academy of Behavioral Finance & Economics
P.O. Box 157
Montrose, CA 91021-0157

Copyright © 2010 Academy of Behavioral Finance & Economics